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For Immediate Release
Friday, May 10, 2002

Grassley Works to Stop Abusive Tax Shelters, Corporate Flight

WASHINGTON – Sen. Chuck Grassley, ranking member of the Committee on Finance, is the lead co-sponsor of new legislation to rein in abusive tax shelters and the sponsor of a pending bill to prevent companies from moving overseas to avoid U.S. taxes.

"Average working Americans can't pull up stakes and move to Bermuda or set up a fancy tax shelter to avoid paying taxes," Grassley said. "Companies that do this make a sucker out of working Americans and companies that stay in the United States and pay their fair share of taxes."

Grassley and Sen. Max Baucus, chairman of the Committee on Finance, last night introduced the *Tax Shelter Transparency Act* (S. 2498). For many years, tax shelter promoters and participants have played a game of hide-and-seek with the Internal Revenue Service, burying their shelters in layers of detail or simply sealing off detection through a web of conspiracy, Grassley said.

Grassley said the new legislation will flush out tax shelters so the IRS can identify them and shut down illegal operations. The bill builds on a proposal from the Department of Treasury that sets clear parameters on what transactions have to be disclosed. Grassley said mere disclosure does not mean that the transaction is a shelter – it simply means that it has the potential to be a tax shelter.

"We can only determine whether it's a tax shelter by giving it a close review," Grassley said. "A tax shelter is a little like pornography. You can't define it, but you know it when you see it. Our bill will make sure the IRS gets to see it."

Grassley said the legislation is important because shelters and their promoters are hiding. The 2001 tax filing season produced only 272 tax shelter return disclosures from only 99 corporate taxpayers, a fraction of transactions that should have been disclosed, Grassley said. Under the *Tax Shelter Transparency Act*, a refusal to disclose a potential shelter will carry heavy consequences. The bill subjects shelter promoters and participants to large cash penalties, increased penalty assessments, and for public companies, mandatory reporting of their shelter activities to the Securities and Exchange Commission.

The tax shelters bill is the second major piece of legislation from Grassley and Baucus to rein in abusive tax practices. Grassley is the sponsor of the *Reversing the Expatriation of Profits Offshore (REPO) Act (S. 2119)*, introduced on April 11. The bill, pending in the Finance Committee, would limit the ability of companies to relocate in name only to a low-tax country such as Bermuda. This week, shareholders of tool maker Stanley Works narrowly approved relocating the company's legal residence to Bermuda, a move that will allow it to avoid some of its U.S. tax obligation. Today, company officials temporarily delayed the move after employees and state officials complained.

Grassley said several factors give Congress unprecedented political will to tackle corporate tax abuses: the publicity of a corrupt corporate culture at the Enron Corp.; disclosures that the recession and the war on terrorism helped companies move overseas to avoid U.S. taxes; and revelations that large accounting firms and large law firms enable and promote abusive tax practices.

"Company officials might say that our international tax rules are flawed," Grassley said. "Sure, our tax system has problems. But the individuals and companies who cheat never try to get the problems resolved. They just do their own thing to get out of paying their fair share. It's obviously time to end abusive tax shelters, and this is the year to do it. We have more political will than ever to get it done."

Attachment: Description of the *Tax Shelter Transparency Act (S. 2498)*

CHAIRMAN MAX BAUCUS (D-MT) AND
RANKING MEMBER CHUCK GRASSLEY (R-IA)

TAX SHELTER TRANSPARENCY ACT

MAY 10, 2002

Introduction

Senate Finance Committee Chairman Max Baucus and Ranking Member Chuck Grassley yesterday introduced legislation to help combat the proliferation of tax shelters. The *Tax Shelter Transparency Act* is a result of efforts which began over two years ago with the work of then-Chairman William V. Roth, Jr. (R-DE) and Ranking Member Daniel Patrick Moynihan (D-NY). At that time, the Secretary of the Treasury stated that tax shelters represented the most significant compliance problem currently confronting our voluntary system of taxation. The Secretary said that tax shelters not only reduce the tax base, they breed disrespect for the system by participants and observers, and waste valuable public and private sector resources.

When these comments were made, there was a more positive outlook regarding the government's ability to curb the promotion and use of abusive tax transactions. The Treasury Department issued regulations requiring disclosure of certain transactions and requiring developers and promoters of tax-engineered transactions to maintain customer lists – and to make these lists available to the IRS. Also, the government had prevailed in several court cases against the use of abusive tax transactions.

Even though it appeared some progress was being made, Chairman Baucus and Ranking Member Grassley believed that additional legislation was needed to strengthen the government's ability to identify and address abusive tax avoidance practices. The uncertainty associated with the disclosure regulations, coupled with the absence of meaningful sanctions, created an environment for noncompliance. Recent events have demonstrated that the Committee's concerns were well-founded. The corporate tax returns that were filed during the fall 2001 filing season were the first to be fully covered by the disclosure regulations. On March 21, Treasury and IRS officials testified before the Finance Committee that only 272 transactions by 99 different taxpayers were disclosed. Moreover, IRS's recent disclosure initiative produced the following example: the IRS inquired of a promoter and received a list of 17 investors. All 17 of the investors should have disclosed their participation to the IRS, but only 5 of the investors actually disclosed. The facts are indisputable: the small number of disclosures has made legislation more important now.

The *Tax Shelter Transparency Act* strengthens the disclosure regime and will alter taxpayers' cost-benefit analysis when they consider participating in such transactions. The bill is similar in approach to the August Finance Committee staff draft and incorporates many of the recommendations proposed by Treasury in March. In fact, new legislation is designed specifically to reinforce the Treasury Department's existing and proposed administrative enforcement regime. The bill gives Treasury broad new authorities to define transactions for purposes of disclosure and authorizes IRS to impose sanctions against those who participate in or promote abusive tax shelter transactions.

Tax shelters generally are highly aggressive positions taken by taxpayers on their tax returns to avoid or evade taxes. Under current law, there are specific sections of the tax code and several penalty provisions that attempt to curtail abuses and encourage compliance. Unfortunately, these specific sections have been enacted on an ad-hoc basis and are generally after-the-fact fixes which constantly keep the Treasury Department and the IRS years behind in their enforcement efforts. Furthermore, the penalty provisions do not encourage taxpayers to disclose questionable items on their tax return nor sufficiently deter them from entering into abusive tax shelters. In most cases, taxpayers have been able to get out from under the penalties either through negotiation or reliance on advisor opinions of dubious quality.

The players involved in abusive tax avoidance transactions include the taxpayer who buys, the promoter who markets, and the tax advisor who provides an opinion "endorsing" the tax-engineered arrangement. The legislation introduced today focuses on the role each plays and proposes to impose meaningful sanctions for engaging in conduct that continues to undermine the integrity of our federal tax system.

The *Tax Shelter Transparency Act* emphasizes disclosure. Chairman Baucus and Ranking Member Grassley believe that disclosure of questionable transactions to the IRS is critical to the Government's ability to identify and address abusive tax avoidance and evasion arrangements. A taxpayer that fails to disclose a transaction in the hopes of hiding in the weeds – hoping to avoid detection by IRS – will be liable for significant sanctions, and in some cases, disclosure to the Securities Exchange Commission (SEC).

The legislation will provide certainty to taxpayers and their tax advisors about registration, list maintenance and disclosure on tax returns. The legislation is intended to remove guesswork and, therefore, the ability of taxpayers and their advisors to manipulate or ignore the current system. Taxpayers and their advisors will know, with a large measure of certainty, what their obligations are under the new regime. There will be no question about whether a particular transaction should be registered or disclosed. To quote the Treasury Department, "If a promoter is comfortable with selling a transaction, a taxpayer is comfortable with entering into that transaction, and a tax practitioner is comfortable with advising that the transaction is proper, then they all should be comfortable with the IRS knowing about and understanding the transaction."

Under the bill, a transaction will be classified into one of three types of transactions for purposes of disclosure and accuracy-related penalties: Listed Transactions, Reportable Transactions, and Other Transactions.

Taxpayers

Listed Transactions

______Listed Transactions are particularly egregious transactions that Treasury considers to be abusive tax shelters. Treasury publicly discloses these transactions so that taxpayers can readily determine whether any of their transactions are Listed Transactions.

Because Listed Transactions are publicly known, the *Tax Shelter Transparency Act* imposes significant penalties for non-disclosure of Listed Transactions. Diagram 1 depicts the penalties that are imposed on listed transactions. Failure by the taxpayer to disclose the transaction results in an automatic flat dollar penalty of $200,000 for large taxpayers (i.e., any corporation, partnership, or trust with gross receipts over $10 million and individuals with net worth over $2 million) and $100,000 for small taxpayers. Additionally, if the taxpayer is required to file with the SEC, the penalty must be reported to the SEC. These penalties are based solely upon the failure to disclose, and do not depend upon the ultimate success of the taxpayer in challenging the merits of their Listed Transaction.

In addition, any underpayment that is attributable to a nondisclosed Listed Transaction will be subject to a 30% strict liability, nonwaivable accuracy-related penalty which must be reported to the SEC. On the other hand, if the taxpayer discloses the Listed Transaction, any tax underpayment that is attributable to the transaction will be subject to a 20% accuracy related penalty.

Reportable Transactions

______Reportable Transactions are transactions that meet one of the objective criteria established by the Department of Treasury. Because the criteria are objective, an obligation to disclose these transactions should be readily discernable. Based on current regulations, and the proposals put forward by the Administration, we anticipate these transactions would include, but would not be limited to: significant loss transactions; transactions with brief asset holding periods; transactions marketed under conditions of confidentiality; transactions subject to indemnification agreements; and certain transactions with a certain amount of book-tax difference.

Diagram 2 sets forth the penalty regime for Reportable Transactions. Failure by the taxpayer to disclose a Reportable Transaction results in an automatic flat dollar penalty of $100,000 for large taxpayers and $50,000 for small taxpayers. There is no SEC reporting requirement for a failure to disclose. These penalties are based solely upon the failure to disclose, and do not depend upon the ultimate success of the taxpayer in challenging the merits of their Reportable Transaction.

Reportable Transactions are then subject to a filter to determine whether there is a significant purpose of tax avoidance that would merit harsher treatment of the transaction. First, any understatement attributable to a nondisclosed Reportable Transaction that has a significant purpose of tax avoidance is subject to a 25% strict liability, nonwaivable accuracy-related penalty which must be reported to the SEC. On the other hand, if a nondisclosed Reportable Transaction does not have a significant purpose of tax avoidance, any tax underpayment attributable to the transaction is subject to a 20% accuracy related penalty, to the extent the underpayment exceeds a certain amount, unless the transaction has a more likely than not probability (greater than 50%) of being sustained on its merits.

Second, if the taxpayer discloses a Reportable Transaction that has a significant purpose of tax avoidance, the taxpayer is not subject to a higher accuracy-related penalty (current 20% applies), the transaction must have a more likely than not probability of being sustained on the merits if challenged by the IRS, and heightened penalty waiver exception requirements apply. If the transaction does not have a significant purpose of tax avoidance, the taxpayer is still not subject to a higher accuracy-related penalty (current 20% applies), the transaction need only have a reasonable basis if challenged by the IRS, and the current law penalty waiver exception requirements apply.

Other Transactions

Transactions that are neither a Listed nor a Reportable Transaction could nevertheless be subject to the accuracy-related penalty. These transactions do not fall within the previous two types of transactions. The legislation makes three modifications to the current law accuracy-related penalty requirements: elevate standards for reporting in order to provide meaningful incentives to disclose; conform standards for taxpayers and tax practitioners; and change the floor for understatements. Diagram 3 sets forth the operation of these modifications. If the taxpayer fails to disclose the transaction, the taxpayer must have a more likely than not belief that the transaction will be sustained on its merits if challenged by the IRS. This standard is higher than "substantial authority", the standard applicable to non-tax shelter transactions under present law. Chairman Baucus and Senator Grassley think a taxpayer should not claim a position on a tax return that the taxpayer does not believe is correct unless this fact is disclosed to the IRS. Also, the definition of "substantiality" for purposes of determining whether there is a substantial understatement is if the amount of the understatement exceeds the lesser of $10 million or 10 percent of the tax required to be shown on the return for the taxable year.

Frivolous Filings

The legislation increases the penalty for filing a frivolous tax return to $5,000.

Reasonable Cause Waiver

A taxpayer may not avoid the penalty through reliance on an opinion that is rendered by a tax advisor who has a financial interest in the transaction or otherwise has a conflict of interest or lack of independence. In addition, a tax opinion based on unreasonable facts, assumptions, or representations will be similarly disqualified, even if it is rendered by an otherwise independent tax advisor.

Advisors and Promoters

To enhance the ability of the IRS and the Treasury Department to obtain information about abusive transactions, the legislation expands the types of transactions that must be registered with the IRS and does not limit the legislation to corporate transactions. The legislation also enhances the government’s ability to enjoin conduct related to tax shelters.

The legislation increases the penalty imposed on material advisors who refuse to maintain lists of their transaction participants, as required by the regulations. Material advisor means any person who provides any material aid, assistance, or advice with respect to organizing, promoting, selling, implementing or carrying out any Reportable Transaction. If a material advisor fails to provide the IRS with a list of investors in a Reportable Transaction within 20 days after receipt of a written request by the IRS to provide such a list, the promoter would be subject to a penalty of $10,000 for each additional day that the requested information is not provided. The penalty would be imposed for each investor list that a promoter fails to maintain or delays in providing to the IRS. The IRS would have the discretion to extend the deadline or waive all or a portion of the penalty upon a showing of reasonable cause.

Because of the important role of tax advisors in our voluntary system of compliance, the legislation adds a provision affirming the authority of the Treasury Department to censure tax advisors or impose monetary sanctions against tax advisors and firms that participate in tax shelter activities and practice before the IRS.

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Chairman Baucus and Ranking Member Grassley welcome public comment on the *Tax Shelter Transparency Act*. Please direct your comments to John Angell, Majority Staff Director, and Kolan L. Davis, Republican Staff Director, of the Senate Finance Committee, 219 Dirksen Senate Building, Washington, D.C. 20510.

Diagrams are attached.